

## Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

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, ID No.

Telephone Number:

Refer Reply To:

CC:PSI:04

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Date:

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### Legend

Settlor =  
Trust Agreement =

Company =  
Son =  
Wife =  
Date 1 =  
Date 2 =  
Date 3 =  
Date 4 =  
Date 5 =  
Year 1 =  
Year 2 =  
Trust 1 =  
Trust 2 =  
Trust 3 =  
State =  
State 1 =  
State Statute =  
Court =  
X =  
Y =

Dear :

This letter responds to the letter dated July 24, 2012, submitted by your authorized representative, requesting rulings regarding the income, gift, and

generation-skipping transfer (GST) tax consequences of a proposed modification to two trusts.

The facts submitted are as follows:

On Date 1, a date prior to September 25, 1985, Settlor executed Trust Agreement to create five separate irrevocable trusts to hold Company stock. Trust 1 was created to benefit Settlor's Son and his issue. Trust 2 was created to benefit Settlor's Wife and the issue of Wife and Settlor.

Article X of Trust Agreement provides that upon the death of Son, the trustees of Trust 1, as they in their unfettered discretion deem wise, shall apply all of the income to Son's issue. Article X also provides that upon the death of Wife, the trustees of Trust 2, as they in their unfettered discretion deem wise, shall apply x percent of the income of Trust 2 to Son and, upon the death of Son, to Son's issue.

Wife died on Date 2. On Date 3, Court partitioned Trust 2 and ordered: (1) that x percent of the assets of Trust 2 be paid and distributed to a separate trust (Trust 3) for the benefit of Son and his issue, and (2) that these assets be held and administered on the same terms and conditions provided for Trust 2 in Trust Agreement. On Date 4, Son died. Pursuant to the terms of Trust Agreement, the current income beneficiaries of Trust 1 and Trust 3 are Son's three children.

On Date 5, Court granted the trustees' petition to remove the administration of Trust 1 and Trust 3 from State to State 1. However, Article XX of Trust Agreement provides that the agreement shall be regarded for all purposes as a State document and that the validity and construction of Trust Agreement shall be determined and governed in all respects by the laws of State.

It is represented that the only other amendments made to Trust 1 and Trust 3 are administrative in nature. It is represented that no additions have been made to these trusts from and after September 25, 1985.

In Year 1, State enacted legislation revising its Principal and Income Act. State Statute authorizes a trustee, at his or her own discretion or at the request of a beneficiary, to convert an eligible trust to a unitrust for purposes of defining trust income, if all of the following apply:

- a. The trustee determines that the conversion will enable the trustee to better carry out the purposes of the trust;
- b. The trustee provides notice of the intention to convert the trust to a unitrust, and the notice advises how the

unitrust will operate, including the fixed percentage and any other initial determinations that the trustee intends to follow;

- c. There is at least one sui juris income beneficiary currently eligible to receive income from the trust and at least one other sui juris beneficiary either eligible to receive, if no powers of appointment were exercised, income from the trust if the interest of all current income beneficiaries were to terminate immediately before the giving of notice or eligible to receive, if no powers of appointment were exercised, a distribution of principal if the trust were to terminate immediately before the giving of the notice;
- d. Every sui juris beneficiary consents to the conversion to a unitrust in a writing delivered to the trustee; and
- e. The terms of the trust describe the amount that may or must be distributed by referring to the trust income.

The trustees of Trust 1 and Trust 3 represent that Trust 1 and Trust 3 are eligible to be converted to unitrusts under State Statute provided the trustees obtain the consent of the current income beneficiaries of Trust 1 and Trust 3. The trustees intend to provide notice to all sui juris beneficiaries of the trustees' intention to convert Trusts 1 and 3 to unitrusts and intend to request the consent of all sui juris beneficiaries of the trusts. The trustees propose to convert Trust 1 and Trust 3 to unitrusts using a unitrust conversion procedure that complies with all of the specific requirements of State Statute. Under the proposal, the income of each trust for Year 2 and future years will be equal to y percent of the net fair market value of the trust's assets, with such value averaged over the prior four (4) years based on the value at the end of each of the sixteen (16) calendar quarters ending with the December 31 value of the prior year. Any income already distributed in Year 2 will be credited against the unitrust amount payable for the current year.

You have requested the following rulings:

- 1. The conversion of Trust 1 and Trust 3 to unitrusts under State Statute effective for Year 2 and future years will not cause Trust 1 and Trust 3 to lose their grandfathered status from GST tax.
- 2. The conversion of Trust 1 and Trust 3 to unitrusts under State Statute effective for Year 2 and future years will not cause any beneficiary of Trust 1 or Trust 3 to be deemed to have made a gift for gift tax purposes.

3. The conversion of Trust 1 and Trust 3 to unitrusts under State Statute effective for Year 2 and future years will not cause Trust 1 or Trust 3, or any beneficiary of Trust 1 or Trust 3, to realize capital gains from an exchange of a trust interest for income tax purposes.

## Law and Analysis

### Ruling Request 1

Section 2601 imposes a tax on every generation-skipping transfer (GST), which is defined under § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under section 1433 of the Tax Reform Act of 1986 (the Act), GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, except to the extent the transfer is made out of corpus added to the trust by an actual or constructive addition after September 25, 1985.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the generation-skipping transfer tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. These rules are applicable only for purposes of determining whether an exempt trust retains exempt status for generation-skipping transfer tax purposes. These rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(D) provides that a modification will not cause an exempt trust to be subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in a beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

Section 26.2601-1(b)(4)(i)(E), Example 11, considers whether the conversion of an income interest into a unitrust interest under a state statute

results in a shift in beneficial interest. In Example 11, in 1980, Grantor, a resident of State X, established an irrevocable trust for the benefit of Grantor's child, A, and A's issue. The trust provides that trust income is payable to A for life and, upon A's death, the remainder is to pass to A's issue, per stirpes. In 2002, State X amends its income and principal statute to define income as a unitrust amount of 4 percent of the fair market value of the trust assets valued annually. For a trust established prior to 2002, the statute provides that the new definition of income will apply only if all the beneficiaries who have an interest in the trust consent to the change within two years after the effective date of the statute. The statute provides specific procedures to establish the consent of the beneficiaries. A and A's issue consent to the change in the definition of income within the time period, and in accordance with procedures prescribed by the state statute. The administration of the trust, in accordance with the state statute defining income to be a 4 percent unitrust amount, will not be considered to shift any beneficial interest in the trust. Therefore, the trust will not be subject to the provisions of chapter 13. Further, under these facts, no trust beneficiary will be treated as having made a gift for federal gift tax purposes, and neither the trust nor any trust beneficiary will be treated as having made a taxable exchange for federal income tax purposes.

In this case, Trusts 1 and 2 were irrevocable on September 25, 1985, and there were no additional contributions to Trusts 1, 2, or 3 after September 25, 1985. Based on the facts submitted and representations made, we conclude that, provided the proposed conversion meets the requirements of State Statute and the beneficiaries of Trusts 1 and 3 consent to the conversion, the conversion of Trust 1 and Trust 3 to unitrusts for Year 2 and future years will not shift any beneficial interest in Trust 1 or Trust 3 and, therefore, will not cause either Trust 1 or Trust 3 to lose its exempt status for GST purposes.

#### Ruling Request 2

Section 2501(a)(1) imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual.

Section 2511(a) provides that the tax imposed by § 2501 shall apply whether the transfer is in trust or otherwise and whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Based on the facts submitted and representations made, we conclude that, provided the proposed conversion meets the requirements of State Statute and the beneficiaries of Trusts 1 and 3 consent to the conversion, the conversion of Trust 1 and Trust 3 to unitrusts for Year 2 and future years will not shift any beneficial interest in Trust 1 or Trust 3 and, therefore, will not result in any beneficiary of Trust 1 or Trust 3 being treated as having made a taxable gift for federal gift tax purposes.

Ruling Request 3

Section 61(a)(3) provides that, except as provided in subtitle A, gross income means all income from whatever source derived, including gains derived from dealings in property. Under § 1.61-1(a) of the Income Tax Regulations, gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services.

Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of adjusted basis provided in § 1011 for determining loss over the amount realized. Under § 1.1001-1(a), except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property differing materially in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received.

Section 1.643(b)-1 provides that for purposes of subparts A through D, part 1, subchapter J, chapter 1 of the Code, “income,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross” means the amount of income of an estate or trust for the taxable year determined under terms of the governing instrument and applicable local law. Section 1.643(b)-1 also provides, in relevant part, that an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3 percent and no more than 5 percent of the fair market value of the trust assets, whether determined annually or averaged on the multiple year basis, is a reasonable apportionment of the total return of the trust.

Section 1.643(b)-1 further provides that a switch between methods of determining trust income authorized by state statute will not constitute a recognition event for purposes of § 1001 and will not result in a taxable gift from the trust’s grantor or any of the trust’s beneficiaries. A switch to a method not specifically authorized by state statute but valid under state law (including a switch via judicial decision or a binding non-judicial settlement) may constitute a recognition event to the trust or its beneficiaries for purposes of § 1001 and may result in taxable gifts from the trust’s grantor and beneficiaries based on the relevant facts and circumstances.

Based on the facts submitted and representations made, we conclude that, provided the proposed conversion meets the requirements of State Statute and the beneficiaries of Trust 1 and Trust 3 consent to the conversion, no gain or loss will be recognized under § 61 by Trust 1, Trust 3, or any beneficiary of Trust 1 or Trust 3 as a result of the proposed conversion of Trust 1 and Trust 3 to unitrusts effective for Year 2 and future years.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

Lorraine E. Gardner  
Senior Counsel, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs and Special Industries)

Enclosures (2)

Copy of this letter

Copy for § 6110 purposes

cc: